Supreme Court, U.S.
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No. 95-

In The

Supreme Court of the United States

October Term, 1995

MARY BRABSON, WILLIAM BRABSON, and HELEN BRABSON,

Petitioners,

v.

UNITED STATES OF AMERICA,

Respondent.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Tenth Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED FOR REVIEW

1. Whether prejudgment interest assessed as compensatory damages for the delay in recovery in a personal injury suit, with the intent of making the victim whole, is excludable from gross income as "any damages . . . received on account of personal injuries . . . " pursuant to 26 U.S.C. § 104(a)(2).

2. Whether federal courts are bound by state law characterizations of damages in determining excludability under § 104(a)(2)?

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PETITION FOR A WRIT OF CERTIORARI

Mary Brabson, William Brabson, and Helen Brabson respectfully petition the Court to issue a writ of certiorari to review the judgment and opinion of the United States Court of Appeals for the Tenth Circuit, issued on January 11, 1996.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Tenth Circuit is reported at 73 F.3d 1040 and is set out in Appendix A. No petition for rehearing was filed. The opinion of the United States District Court for the District of Colorado is reported at 859 F.Supp. 1360 and is set out in Appendix B.

JURISDICTION OF THE SUPREME COURT

The judgment and opinion of the United States Court of Appeals for the Tenth Circuit were issued on January 11, 1996. Jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1254(1). This petition is timely filed on Wednesday, April 10, 1996, which is the 90th day after the opinion was issued by the Court of Appeals. Rule 13.1 of the United States Supreme Court.

STATUTORY PROVISIONS AND TREASURY REGULATIONS INVOLVED IN THIS CASE

The Internal Revenue Code, at 26 U.S.C. § 61, states in relevant part,

> **SEC. 61. GROSS INCOME DEFINED.**
>
> (a) General Definition. – Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:
>
> (4) Interest;

The Internal Revenue Code, at 26 U.S.C. § 104, states in relevant part,

> **SEC. 104. COMPENSATION FOR INJURIES OR SICKNESS.**
>
> (a) In General. – Except in the case of amounts attributable to (and not to excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include –
>
> (2) the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness. . . .

Treasury Regulations, at 26 C.F.R., state in relevant part,

> **§ 1.61-7. Interest.**
>
> (a) In general. As a general rule, interest received by or credited to the taxpayer constitutes gross income and is fully taxable. Interest income includes interest on savings or other bank deposits; interest on coupon bonds; interest on an open account, a promissory note, a

mortgage, or a corporate bond or debenture; the interest portion of a condemnation award; usurious interest (unless by State law it is automatically converted to a payment on the principal); interest on legacies; interest on life insurance proceeds held under an agreement to pay interest thereon; and interest on refunds of Federal taxes. . . .

§ 1.104-1. Compensation for injuries or sickness. –

(c) Damages received on account of personal injuries or sickness. – Section 104(a)(2) excludes from gross income the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness. The term "damages received (whether by suit or agreement)" means an amount received (other than workmen's compensation) through prosecution of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution.

Section 13-21-101(1), 6A C.R.S. (1987 Repl.Vol.), states in relevant part,

13-21-101. Interest on damages. (1) In all actions brought to recover damages for personal injuries sustained by any person resulting from or occasioned by the tort of any other person, corporation, association, or partnership, whether by negligence or by willful intent of such other person, corporation, association, or partnership and whether such injury has resulted fatally or otherwise . . . it is lawful for the plaintiff in the complaint to claim interest on the damages claimed from the date the action accrued. When such interest is so claimed, it is

> the duty of the court in entering judgment for the plaintiff in such action to add to the amount of damages assessed by the verdict of the jury, or found by the court, interest on such amount calculated at the rate of nine percent per annum . . .

STATEMENT OF THE CASE

Petitioner Mary Brabson is the mother of William and Helen Brabson, who were minors on July 15, 1981, when all three were physically injured in a gas explosion at their residence in Colorado Springs. They filed negligence actions against the three responsible parties in the El Paso County District Court.

The jury awarded Mary $ 1,600,000 for her personal injuries. It also awarded $ 300,000 to Helen and $ 160,000 to William. The district court entered judgment on these verdicts and assessed prejudgment interest pursuant to section 13-21-101(1), 6A C.R.S. (1987 Repl.Vol.).[1]

---

[1] Prejudgment interest in Colorado "is an element of compensatory damages in actions for personal injuries, awarded to compensate the plaintiff for the time value of the award eventually obtained against the tortfeasor." *Allstate Insurance Company v. Starke*, 797 P.2d 14, 19 (Colo. 1990). It is awarded because it is "necessary to make the plaintiff whole." *Seward Construction Company v. Bradley*, 817 P.2d 971, 975 (Colo. 1991). Because it is an element of damages, it is wholly distinct from post-judgment interest. Furthermore, it is "misleading" to call it "interest", "for where allowed it is awarded not as interest as such but as damages." *Allstate Insurance*, 797 P.2d at 18.

While the appeal was pending, two of the defendants settled for a $ 155,948.87 lump sum. In an unpublished opinion, the Colorado Court of Appeals affirmed as to the remaining defendant, and after granting certiorari, the Colorado Supreme Court denied the petition as being improvidently granted. On June 28, 1988, the defendant paid the full amount of the judgment and prejudgment interest, minus the lump sum paid by the other defendants.

None of the Brabsons declared this interest on their 1988 federal income tax returns, maintaining that it constituted damages received on account of personal injuries and was therefore excludable from their taxable income pursuant to 26 U.S.C. § 104(a)(2).

The Internal Revenue Service disagreed and assessed deficiencies against them for taxes on the interest portion of their personal injury awards. Petitioners paid these deficiencies and sued to recover them in the United States District Court for the District of Colorado, which had jurisdiction pursuant to 28 U.S.C. § 1346(a)(1).

The district court, per Kane, J., followed the Tax Court's analysis in *Horton v. Commissioner of Internal Revenue*, 100 T.C. 93 (February 9, 1993):

> Whether the damages paid to the tort victim reflect a substitute for amounts or items otherwise taxable or a substitute for amounts or items to be enjoyed without a tax consequence is irrelevant. Thus, section 104(a)(2) permits the exclusion of damages that are a substitute for the enjoyment of a whole body or of freedom from distress. . . . Likewise, the section allows exclusion of damages that are a substitute for *amounts*

> or *items* that *otherwise would be taxable* or would potentially produce taxable benefit, such as income lost as a result of a personal injury or amounts reflecting injury to a person's business or professional reputation.

100 T.C. at 96 n.4, quoting *Downey v. Commissioner*, 97 T.C. 150, 163-164 (1991) (emphasis added by Judge Kane). App. at ___. Based upon this analysis, Judge Kane held that "When items otherwise taxable are awarded as damages for personal injuries, their character as 'otherwise taxable' becomes irrelevant and they are excluded from income. Thus, even if prejudgment interest were 'otherwise taxable,' once it is awarded as damages for personal injuries that fact becomes irrelevant and it is excludable from income." (emphasis in original) App. at 33-34.

In response to the government's argument that the real question was "not whether the prejudgment interest was an 'amount received' by the Brabsons through prosection of . . . [a] personal injury action, but whether it constitutes 'damages' as contemplated by § 104(a)(2)", App. at 24, Judge Kane stated that because there was no federal common law of torts and no controlling definition in the Tax Code, this question must be answered by looking to state law. App. at 25. After reviewing cases such as *Allstate Insurance v. Starke, supra*, he found that under Colorado law, prejudgment interest was indeed an element of compensatory damages in personal injury cases. Hence, it was "damages received . . . on account of personal injuries" within the meaning of section 104(a)(2). App. at 26-29, 31.

Judge Kane noted that to the extent this conclusion conflicts with the Tax Court's recent ruling in *Kovacs v.*

Commissioner, 100 T.C. 124 (1993), *aff'd in unpublished disposition*, 94 WL 253035 (June 9, 1994), "I decline to follow the *Kovacs* majority, and adopt instead the analysis of Judge Beghe in dissent."[2] App. at 32. He noted that the opinions relied upon by the *Kovacs* majority dealt with post-judgment, rather than pre-judgment interest, App. at 34-35, and quoted with approval the following statement from *NV Koninlijke Hollandische Lloyd (Royal Holland Lloyd) v. Commissioner*, 34 B.T.A. 830, 835 (1936), a case he found squarely on point and far more compelling than *Kovacs*:

> Just compensation for the damage so suffered requires that the party damaged be made whole. An integral part of a payment for such purpose is interest covering the period of detention. In such a case [interest] is merely a convenient method of measuring the amount of one of the factors of damage. *It is not a separate item of interest on an obligation.*

(emphasis added by Judge Kane) App. at 36-37.

Judge Kane then discussed the fundamental difference between prejudgment interest and postjudgment interest:

> [T]he obligation to pay prejudgment interest is tied inextricably to the concept of fault. Before liability is fixed, prejudgment interest is part of plaintiff's damage demand on a contingent and unliquidated claim and accrues until judgment enters against the defendant. *Starke*, 797 P.2d at 19; *Houser*, 532 P.2d at 57. Once defendant's

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[2] This Court denied certiorari in the *Kovacs* case. *Kovacs v. United States*, case no. 94-423.

> liability in tort is fixed, his liability for the lost time-value of plaintiff's award also becomes fixed. Prejudgment interest is awarded to compensate for this loss and becomes a "part" of plaintiff's lump-sum damages. C.R.S. § 13-21-101; *see Turcotte*, 131 N.E.2d at 197 (damages is the word expressing in dollars and cents the injury sustained by a personal injury plaintiff; it includes both the original damage and whatever interest is added to make the plaintiff whole).
>
> The obligation to pay postjudgment interest, by contrast, is not directly tied to the concept of fault. Like conventional interest, postjudgment interest accrues on a fixed indebtedness. See, *Old Colony Railroad Co. v. Comm'r*, 284 U.S. 552, 560 (1932). It compensates a judgment creditor for the debtor's use, or the creditor's forbearance in demanding, payment of an amount fixed and owed by the debtor. See, *Deputy v. du Pont*, 308 U.S. 488, 498 (1940). It is the equivalent of 'rent' for the use of funds due and owing to the plaintiff. See, *Dickman v. Comm'r*, 465 U.S. 330, 339 (1984). Prejudgment interest does not fit into these definitions of interest because at the time it accrues, plaintiff is not a creditor and there is no debt fixed or owed by the defendant to him. Plaintiff can neither demand, nor forbear from demanding, payment.

App. at 27-29.

Although the Tenth Circuit found "merit in each position" on this "difficult question" and although it believed that the taxpayers' construction of section 104(a)(2) was "not irrational", App. at 6, 17, it nonetheless reversed the district court. Like the district court,

however, it rejected the Tax Court's approach to the problem, articulated in *Kovacs* and its progeny, as being overly simplistic and relying on form over substance. App. at 11.

The court agreed that petitioners had received prejudgment interest as a result of personal injuries caused by tortious conduct, but held that under *Commissioner of Internal Revenue v. Schleier*, ___ U.S. ___, 115 S.Ct. 2159 (1995), this was only the beginning of the analysis. The next step was to determine the nature of the damages claimed to be excludable under section 104(a)(2). App. at 7-8. It acknowledged that this determination must be made with reference to state law, and agreed with the district court that under Colorado law, prejudgment interest was an element of compensatory damages in personal injury cases. App. at 9-10.

Notwithstanding Colorado law, however, the court said that it would "hesitate" to find prejudgment interest excludable because it was a "contract-type" damage for pecuniary harm and was not consistent with "traditional tort concepts." App. at 14-15.

As it did in *O'Gilvie v. United States*, 66 F.3d 1550 (10th Cir. 1995) (cert. granted, March 25, 1996, Cases No. 95-966 and 95-977), the court found that section 104(a)(2) was ambiguous. App. at 7, 10. It then followed *O'Gilvie* and tipped the scale with its interpretation of the default rule:

> Lastly, though perhaps most importantly, we are guided by the default rule that "exclusions form income must be narrowly construed." Although we think that the taxation of prejudgment interest is consistent with congressional intent, even if "good reasons tug[ged] each way," we would

> be required to hold that section 104(a)(2) does not exclude Taxpayers' prejudgment interest from income. *O'Gilvie*, 66 F.3d at 1560. (citation and internal quotation marks omitted)

App. at 16-17.

O'Gilvie concluded with nearly identical language:

> In sum, it is not clear whether Congress intended to exclude punitive damages from income under section 104(a)(2). Although "good reasons tug each way," in this case, we need not decide "which tug harder," because we must follow the default rule that exclusions from income are narrowly construed . . .

66 F.3d at 1560.

REASONS FOR GRANTING THE WRIT

A

This Case Presents The Same Basic Questions About The Construction And Interpretation Of Section 104(a)(2) As Another Case In Which This Court Granted Certiorari On March 25th

In granting certiorari in *O'Gilvie v. United States*, No. 95-966, and *O'Gilvie v. United States*, No. 95-977 (cases consolidated for oral argument), the Court agreed to determine whether punitive damages accompanying a personal injury award were intended by Congress to be included within the phrase "any damages received . . . on account of personal injuries" in 26 U.S.C. § 104(a)(2).

Although this case involves prejudgment interest damages rather than punitive damages, the excludability

of prejudgment interest is at least as important for this Court to resolve as the excludability of punitive damages.

Thirty-four states[3] – Alaska, California, Colorado, Connecticut, Georgia, Hawaii, Indiana, Iowa, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Carolina, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Dakota, Texas, Utah, Vermont, Virginia, West Virginia, and Wisconsin – allow some form of prejudgment interest on personal injury awards.

Prejudgment interest is generally regarded as a form of compensation necessary to make the tort victim whole because of the delay in his recovery of other damages. *See, e.g., Farm Bureau Mutual Insurance Company v. Milne,* 424 N.W.2d 422 (Iowa 1988) (compensatory damages); *Guin v. Ha,* 591 P.2d 1281 (Alaska 1979) (same); *Gordon Sle-Way, Inc. v. Spence,* 438 Mich. 488, 475 N.W.2d 704 (1991) (same); *Lineman v. Schmid,* 32 Cal.2d 204, 195 P.2d 408 (1948) (same); *Turcotte v. DeWitt,* 333 Mass. 389, 131 N.E.2d 195 (1955) (same). *Accord*: *Kovacs v. Commissioner,* 100 T.C. 124, 142 (1993) (Bege, J., dissenting), citing McCormick, *Handbook on the Law of Damages,* § 50, at page 205 (1935) and *Law of Remedies,* § 3.5., 2 Dan B. Dobbs, *Law of Remedies,* § 3.5 (Practitioner Treatise Series, 1993) *See also, Monessen v. Southwestern Railroad Company,* 486 U.S. 330, 335 (1988); *West Virginia v. United States,* 497 U.S.

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[3] Statutory citations and a summary of their provisions are set out in Appendix C. *See also,* 2 Dan B. Dobbs, *Law of Remedies,* § 3.6(2) at 346-348 (Practitioner Treatise Series 1993) (comparing statutes)

305, 310 (1987); *General Motors Corporation v. Devex Corporation*, 461 U.S. 654, 655-656 (1983). The question of whether that interest "as damages" is taxable is one of consummate importance to the hundreds of thousands of recipients of personal injury awards in nearly two-thirds of the states – just as it is to the Internal Revenue Service.

The Court can resolve this significant question by granting certiorari and treating this case as a companion to *O'Gilvie* – something which can be accomplished without any delay in resolving *O'Gilvie* because the cases have arrived here at nearly the same time. Treating them as companion cases is especially appropriate since both cases involve the construction and application of the same federal statute to different but similar situations.

B

The Opinion of the Tenth Circuit Conflicts With the Opinion of this Court in *Commissioner of Internal Revenue v. Schleier*

Although the Tenth Circuit cited to and purported to rely upon *Commissioner of Internal Revenue v. Schleier*, ___ U.S. ___, 115 S.Ct. 2159 (1995), it found that section 104(a)(2) was "ambiguous." App. at 7, 10. *Schleier*, however, refers to "the plain language of § 104(a)(2)" no fewer than five times. 115 S.Ct. at 2163, 2164, 2165, and 2167.

Language cannot simultaneously be "plain" and "ambiguous": it is either one or the other. The court of appeals' finding of ambiguity thus stands in sharp conflict with this Court's finding in *Schleier* that there is no ambiguity, and must be corrected lest the Tenth Circuit

and other circuits compound the error in deciding other cases under section 104(a)(2).

Furthermore, *Schleier* suggests that if the damages are sustained as a result of tortious conduct and are compensatory, they are excludable: " . . . If Congress had intended the ADEA's liquidated damages to compensate plaintiffs for personal injuries, those damages might well come within § 104(a)(2)'s exclusions." 115 S.Ct. at 2165.

The Tenth Circuit acknowledged that Colorado law considers prejudgment interest to be an element of compensatory damages in personal injury cases. It nonetheless ignored Colorado law altogether and held that notwithstanding the compensable contract of prejudgment interest damages, they were not excludable, in part because they were a "contract type" remedy rather than a "traditional" tort remedy. App. at 12-15.

The Tenth Circuit's failure to properly consider the compensatory nature of prejudgment interest under Colorado law is inconsistent with *Schleier*. So, too, is the Tenth Circuit's suggestion that only "traditional" tort damages may be excludable under section 104(a)(2): nothing in *Schleier* restricts excludability to so-called "traditional" damages because under *Schleier*, the test is simply whether damages are awarded "on account of personal injuries." 115 S.Ct. at 2167.

C

The Tenth Circuit's Characterization Of Prejudgment Interest as a Contract Type Remedy Violates the Rule of Deference to State Law Definitions of Property Interests, and Hence Conflicts with Long-Standing Precedent of this Court, of Other Circuits, and of The Tenth Circuit Itself

It has long been the rule that federal courts must defer to state law for a determination of property interests before deciding whether those interests are taxable under federal law. *United States v. Mitchell*, 403 U.S. 190, 197 (1971), quoting *Burnet v. Harmel*, 287 U.S. 103, 110 (1932). *See also, Imel v. United States*, 523 F.2d 853 (10th Cir. 1975), where the Tenth Circuit looked to Colorado law to determine whether a property division made pursuant to a divorce decree was a sale or exchange resulting in a taxable capital gain under federal law. The court specifically held that:

> The basic argument of the government is that a state court cannot determine what is a taxable event under the federal income tax laws. The occurrence of a taxable event in the situation presented depends on whether the transaction was a nontaxable division of property by co-owners or was a sale or exchange resulting in a [taxable] capital gain. . . . Ownership is determined by the law of Colorado. . . . Federal law determines what transactions involving interest or rights created by state law shall be taxed.

This rule has been followed by a number of courts to determine excludability under section 104(a)(1), including the district court below. *See*, e.g., *Commissioner v. Miller*, 914 P.2d 586, 589 (4th Cir. 1990), where the court

examined the purpose of a punitive damages award under Maryland law to determine whether punitive damages in a Maryland defamation action were excludable under section 104(a)(2); *Horton v. Commissioner*, 190 T.C. 93, 100 (1993) (in Kentucky, punitive damages serve "both to compensate the injured party and punish the wrongdoer" and are excludable under § 104(a)(2)); *Burford v. United States*, 642 F.Supp. 635, 638, n.5 (N.D.Ala. 1986) (though labeled "punitive," Alabama wrongful death award compensates plaintiff for her loss and thus is excludable from income); *Reese v. United States*, 24 F.3d 228, 232 (Fed.Cir. 1994) (punitive damage awards for violation of the District of Columbia Human Rights Act are to deter and punish defendant, not to compensate plaintiffs, and punitive damage awards not excludable under § 104(a)(2); *Commissioner of Internal Revenue v. Miller*, 914 F.2d 586, 589 (4th Cir. 1990) (under Maryland law, punitive damages are "inherently different" from compensatory damages and therefore not excludable under § 104(a)(2)); *Wesson v. United* States, 843 F.Supp. 1119, 1122 (S.D.Miss. 1994) (same, applying Mississippi law).

Here, the Tenth Circuit acknowledged this rule as an abstract proposition and then decided the case as if the rule did not exist.

The court agreed that under Colorado law, prejudgment interest in personal injury cases was an element of compensatory damages, distinct from post-judgment interest, and that it was intended to compensate the tort victim for the delay between his injury and his recovery, and thus, to make him whole again. The Tenth Circuit

then ignored this well-established state law and recharacterized prejudgment interest from an element of compensatory tort damages to a "type of contract remedy" which differs from "traditional tort concepts" and which is "contrary to the concept of damages for personal injuries as understood in Revenue Act of 1918 and maintained ever since." App. at 14-15.

Having thus recharacterized prejudgment interest, the court felt it could not find it excludable under section 104(a)(2) because under the recharacterization, prejudgment interest was not any kind of "damages received . . . on account of personal injuries."

This turns the rule of deference to state law definitions of property interests on its head and allows federal courts to redefine those interests without regard to state law. It also means that at least for purposes of section 104(a)(2), state law concepts of tort damages are frozen into the "traditional" rules as they existed in 1918.

CONCLUSION

For all of the above reasons, the petition should be granted.

Respectfully submitted,

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April 10, 1996

No. 95-___

In The

Supreme Court of the United States

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MARY BRABSON, WILLIAM BRABSON,
and HELEN BRABSON,

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UNITED STATES OF AMERICA,

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On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Tenth Circuit

APPENDIX TO THE PETITION FOR WRIT OF CERTIORARI

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APPENDIX A

The Opinion of the United States
Court of Appeals for the Tenth Circuit

PUBLISH

UNITED STATES COURT OF APPEALS

TENTH CIRCUIT

MARY BRABSON, et al., Plaintiffs-Appellees,	)	
v.	)	No. 94-1591
UNITED STATES OF AMERICA, Defendant-Appellant.	)	

Appeal from the United States District Court
for the District of Colorado
(D.C. No. 93-K-2288)

Kenneth W. Rosenberg, Attorney, Tax Division, Department of Justice (Ann B. Durney, Attorney, Department of Justice, with him on brief), Washington, D.C., for Defendant-Appellant.

W. Thomas Beltz (H. William Mahaffey with him on the brief, of Rothgerber, Appel, Powers & Johnson), Colorado Springs, Colorado, for Plaintiffs-Appellees.

Before SEYMOUR, COFFIN[1] and MCKAY, Circuit Judges.

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[1] The Honorable Frank M. Coffin, United States Senior Circuit Judge for the First Circuit, sitting by designation.

COFFIN, Senior Circuit Judge.

In this case, we must determine whether statutorily mandated prejudgment interest awarded in a personal injury suit is "damages received . . . on account of personal injuries or sickness" within the meaning of § 104(1)(2) of the Internal Revenue Code. The district court, on the United States' motion to dismiss, found for the taxpayer-appellees, Mary, Helen, and William Brabson (collectively the "Taxpayers" or "Brabsons"), and held that under Colorado law, prejudgment interest is an element of compensatory damages excludable from income under § 104(a)(2). *See Brabson v. United States*, 859 F. Supp. 1360 (D. Colo. 1994). We conclude, however, that considerations of federal law require reversal.

I. BACKGROUND

On July 15, 1981, Mary Brabson and her children, Helen and William, were injured in an explosion caused by a gas leak in their home. Mary Brabson, on behalf of herself and her children, sued the City of Colorado Springs, Stratmoor Hills Water District, and Stratmoor Hills Sanitation District. On October 29, 1983, after a jury trial, the court entered judgment for the Brabsons awarding damages for personal and property injuries, and statutory prejudgment interest on this amount dating from the time of the explosion.

The defendants appealed, the Stratmoor Hills parties subsequently settled, and in November 1986, the Colorado Court of Appeals affirmed the judgment. The City of

Colorado Springs filed a petition for a writ of certiorari in the Colorado Supreme Court that was initially granted but then, following oral argument on April 25, 1988, denied.

In June 1988, the City of Colorado Springs satisfied the judgment. The Brabsons did not include the amount characterized as prejudgment interest on their 1988 federal income tax returns, and were assessed deficiencies for the excluded amount. After paying the deficiencies, the Brabsons brought suit to recover the amounts paid, plus interest and attorney's fees. The district court found for the Brabsons, holding that prejudgment interest awarded pursuant to Colo. Rev. Stat. § 13-21-101(1) (1979) is an element of damages excludable from income within the meaning of § 104(a)(2) of the Internal Revenue Code. 859 F. Supp. at 1370. This appeal by the government followed.

II. DISCUSSION

The facts are not in dispute. We review *de novo* the legal question of whether prejudgment interest is properly excludable under § 104(a)(2). *See O'Gilvie v. United States*, 66 F.3d 1550, 1555 (10th Cir. 1995). We shall review relevant statutory provisions, set out the competing positions as reflected in the caselaw on point, then turn to our own analysis of the issue.

A. Introduction

1. The Relevant Code Provisions

"Gross income" is defined in § 61(a) of the Internal Revenue Code: "Except as otherwise provided in this

subtitle, gross income means all income from whatever source derived." 26 U.S.C. § 61(a). Since its enactment, the "sweeping scope" of this section and its predecessors has been repeatedly emphasized by the Supreme Court. *Schleier v. Commissioner*, 115 S.Ct. 2159, 2163 (1995); *O'Gilvie*, 66 F.3d at 1555. Thus, any gain constitutes gross income unless the taxpayer demonstrates that it falls within a specific exemption. *Wesson v. United States*, 48 F.3d 894, 898 (5th Cir. 1995); *see Schleier*, 115 S.Ct. at 2163; *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 430 (1955).

The exclusion at issue here, § 104(a) of the Code, provides, in relevant part,

> gross income does not include –
>
> (2) the amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness.

26 U.S.C. § 104(a)(2). In interpreting the breadth of § 104(a)(2), we are guided by the corollary to § 61(a)'s broad construction, the "default rule of statutory interpretation that exclusions from income must be narrowly construed." *Schleier*, 115 S.Ct. at 2163; *O'Gilvie*, 66 F.3d at 1560.

The tension between §§ 61(a) and 104(a) is the nub of this dispute. The Taxpayers contend that prejudgment interest, as provided for by Colorado law, falls within the specific exclusion of § 104(a)(2). In contrast, the government argues that interest is not an element of § 104(a)(2) damages but rather is expressly defined as income under § 61(a)(4).

2. Relevant Caselaw

The parties' contrary positions are a reflection of the cases that have addressed this issue. Beginning with *Kovacs v. Commissioner*, 100 T.C. 124 (1993), *aff'd without published opinion*, 25 F.3d 1048 (6th Cir. 1994), the Tax Court uniformly has held that prejudgment interest is taxable.

Kovacs involved the statutory assessment of prejudgment interest under Michigan law on a wrongful death claim. Relying on the principle that "the words of statutes – including revenue acts – should be interpreted where possible in their ordinary, everyday senses," *id.* at 128 (quoting *Crane v. Commissioner*, 331 U.S. 1, 6 (1947)), the court found a clear demarcation between "damages" and "interest" and emphasized that § 104(a)(2) referred only to "damages." In addition, the court stressed the usual practice of taxing interest, noting in particular that it had found no cases that supported the taxpayers' position. Finally, the court noted that its decision was consistent with Michigan law, which clearly distinguished between "damages" and "interest." The Tax Court's subsequent decisions, relying on *Kovacs*, consistently have held that prejudgment interest is taxable, regardless of how the state characterizes its prejudgment statute or whether the final disposition is judgment or settlement. *See Burns v. Commissioner*, 67 T.C.M. (CCH) 3116 (1994); *Robinson v. Commissioner*, 102 T.C. 116, 126 (1994), *aff'd in part and rev'd in part*, 70 F.3d 34 (5th Cir. 1995); *Delaney v. Commissioner*, 70 T.C.M. (CCH) 353 (1995); *Forest v. Commissioner*, 70 T.C.M. (CCH) 349 (1995).

The district court forthrightly attacked the reasoning of *Kovacs*. *See* 859 F.Supp. 1366-70. Discarding the "interest is interest" equation as "tautology," *id.* at 1368, the court undertook a thorough analysis of the concept of interest and damages and arrived at a contrary conclusion. The crux of the court's decision was that under Colorado law, prejudgment interest is characterized as damages. *Id.* at 1363-66.[2]

We see merit in each position. As, this is the first published opinion from a court of appeals reviewing *Kovacs* and its progeny, we embark on a thorough exploration of this difficult question.

B. Our Analysis

The task before us is to determine whether prejudgment interest on tort damages is excludable as "damages"

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[2] In support of its theory that the characterization of "interest" as "damages" resolves the tax question, the district court relied primarily on a United States Board of Tax Appeals case, *N.V. Koninklijke Hollandische Lloyd (Royal Holland Lloyd)* v. *Commissioner*, 34 B.T.A. 830 (1936). *See* 859 F.Supp. at 1367-68. We think it is inapposite. *Royal Holland* involved the unlawful detainment by the United States of a foreign vessel in New York Harbor. The foreign owner of the vessel sued the United States government and received damages and interest, both of which were held to be excludable from income. However, because Royal Holland was a foreign corporation, the taxability of the interest was governed by § 119(a) of the Revenue Act of 1932. Unlike § 61(a) and its statutory predecessor, § 22(a), § 119(a) did not broadly define income. Rather, "the income shown to be taxed [had to] come strictly within the limits of the statutory requirements." 34 B.T.A. at 834.

under § 104(a)(2). We begin by reviewing the Supreme Court's most recent discussion of the provision in *Schleier*, and then consider the nature of the prejudgment interest award under Colorado law. Having thus set the framework, we reexamine the statutory language, and because we determine that it is ambiguous, we turn to consider legislative intent.

1. Schleier

In holding that a plaintiff's recovery under the ADEA is not excludable from gross income under § 104 (a)(2), 115 S.Ct. at 2163, the Supreme Court enunciated the proper approach to be followed in applying the provision:

> In sum, the plain language of § 104(a)(2), the text of the applicable regulation [26 C.F.R. § 1.104-1(C)], and our decision in *Burke* [504 U.S. 229 (1992)] establish two independent requirements that a taxpayer must meet before a recovery may be excluded under § 104(a)(2). First, the taxpayer must demonstrate that the underlying cause of action giving rise to the recovery is "based upon tort or tort-type rights"; and second, the taxpayer must show that the damages were received "on account of personal injuries or sickness."

Id. at 2167.

Schleier makes clear that all elements of a damage award received by a taxpayer must satisfy these two prongs. Justice Stevens for the Court described a hypothetical car accident that caused the victim to suffer medical expenses, lost wages, and pain, suffering and

emotional distress. The resulting settlement is excludable in full, he explained, not simply because the taxpayer received a tort settlement, but because each element of the tort award was "damages . . . received 'on account of injuries or sickness.' " *Id.* at 2164. In other words, each element of damages was linked to the injury itself.

In this case, there is no dispute that the Taxpayers satisfy the first prong: the award of prejudgment interest was based upon a tort. However, for the Taxpayers to prevail, they must demonstrate that the interest here is "damages," and further, that recovery of such "damages" was "on account of injuries" – i.e., attributable to the injuries suffered in the explosion. We therefore look to Colorado law to determine how, if at all, it plays a part in deciding these issues.

2. Colorado Law

We note at the outset that state law determines the nature of the legal interests and rights created by state law, but that the federal tax consequences pertaining to such interests and rights are solely a matter of federal law. *See Helvering v. Stuart*, 317 U.S. 154, 162 (1942); *Lyeth v. Hoey*, 305 U.S. 188, 194 (1938); *Imel v. United States*, 523 F.2d 853, 855 (10th Cir. 1975). In *O'Gilvie*, for example, in discussing whether punitive damages were excludable under § 104(a)(2), we noted that other circuits faced with the same question looked to state law to determine whether punitive damages were compensatory in nature. 66 F.3d at 1556 n.10. Here, analogously, we look to state law to determine the nature of the payment of prejudgment interest.

The Colorado statute mandating prejudgment interest for personal injury claims provides:

> (1) In all actions brought to recover damages for personal injuries sustained[,] . . . it is lawful for the plaintiff in the complaint to claim interest on the damages alleged. . . . When such interest is so claimed, it is the duty of the court in entering judgment for the plaintiff in such action to add to the amount of damages assessed . . . interest . . . calculated from the date such suit was filed to the date of satisfying the judgment. . . .

Colo. Rev. Stat. § 13-21-101(1).[3]

In interpreting the statute, the Colorado Supreme Court has held that: "prejudgment interest is an element of compensatory damages in actions for personal injuries, awarded to compensate the plaintiff for the time value of the award eventually obtained against the tortfeaser." *Allstate Ins. Co. v. Starke*, 797 P.2d 14, 19 (Colo. 1990). It is treated as another item of damages, *id.*, which "is necessary to make the plaintiff whole." *Seaward Constr. Co. v. Bradley*, 817 P.2d 971, 975 (Colo. 1991).

The rulings quoted above from *Starke* and *Bradley* provoke the strongest arguments on both sides of this

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[3] Another sentence of the subsection provides that "after July 1, 1979, it is lawful for the plaintiff in the complaint to claim interest on the damages claimed from the date *the action accrued.*" *Id.* (emphasis added). Despite this internal ambiguity, Colorado courts have held that interest is calculated from the date the action accrued. *See* Gregory B. Cairns and John C. Tredennick, Jr., *Collection Pre- and Post-Judgment Interest in Colorado: A Primer*, 15 Colo. Law. 753, 756-57 (1986).

debate. The government contends that interest that compensates for the time value of money – whether damages or not – is distinguishable from damages that recompense the underlying injury. The Brabsons counter that any type of damages that serve to compensate an injured person is excludable.

One thing is clear. Under Colorado law, the nature of the prejudgment interest is to compensate the injured victim for the lost time value of money. While Colorado has characterized this compensation as an element of damages, the taxability of this interest is purely a question of federal law. *See Imel*, 523 F.2d at 855.

Our question has therefore become narrowed. Accepting that prejudgment interest under Colorado law compensates plaintiffs for the lost time value of money, and constitutes an element of damages, we still must determine whether the interest is "damages received . . . on account of personal injury" under § 104(a)(2)?

3. Statutory Language

a. Section 104(a)(2)

The plain language of the statute provides no guidance on this question. The Taxpayers argue that the word "any" in conjunction with "damages" in § 104(a)(2) clearly "broadens the definition of damages" so that "all elements of damages including interest on a judgment" are encompassed. The word "any," however, cannot alter the meaning of "damages," and it therefore sheds no light on the issue at hand: whether prejudgment interest *is* "damages . . . on account of personal injury."

Nor do we find compelling the Tax Court's approach to the language, which is simply to rely on the fact that interest and damages as generally understood and defined were separate concepts.[4] *Kovacs*, 100 T.C. at 129. After all, "compensation for services" as used in § 61(a)(1) of the Code is also definitionally a separate concept from "damages," yet it is undisputed that lost wages are excludable under § 104(a)(2). *See Schleier*, 115 S.Ct. at 2164. Moreover, labels take us only so far; for federal tax purposes, we focus on substance over form. *See Commissioner v. Court Holding Co.*, 324 U.S. 331, 334 (1994).

b. Treasury Regulation 1.104-1(c)

The regulation promulgated by the Treasury Department under § 104(a)(2) is likewise unhelpful. Regulation 1.104-1(c) provides that "[t]the term 'damages received (whether by suit or agreement)' means an amount received . . . through prosecution of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution." 26 C.F.R. § 1.104-1(c). While an award of interest could fall neatly within this definition – it is an "amount received . . . through prosecution of a legal suit" – we note that the regulation does not define "on account of personal injuries or sickness." Nor have we read the

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[4] Citing *Webster's Third New International Dictionary* (1986), the Tax Court defined "damages" as the "compensation or satisfaction imposed by law for a wrong or injury," and "interest" as the price paid for borrowing [i.e., withholding] money." *Id.*

regulation this broadly. Although punitive damages are clearly a form of "damages" and "an amount received . . . through prosecution," we have held that they are not excludable under § 104(a)(2). *See O'Gilvie*, 66 F.3d at 1560.

Having found no answer to our question in the language of § 104(a)(2) and its related regulation, we thus turn to congressional intent.

4. Congressional Intent

Alone, analysis of the scant legislative history of § 213(b)(6), the statutory predecessor of § 104(a)(2), does not resolve our quandary. Courts have generally read the legislative history as demonstrating Congress' intent to exclude amounts that constitute replacement of losses resulting from injury or sickness. *See Reese v. United States*, 24 F.3d 228, 231 (Fed.Cir. 1994); *Wesson*, 48 F.3d at 899; *Hawkins v. United States*, 30 F.3d 1077, 1083 (9th Cir. 1994) ("Damages paid for personal injuries are excluded from gross income because they make the taxpayer whole from a previous loss of personal rights – because, in effect, they restore a loss of capital.") (citation and internal quotation marks omitted). Because compensating a plaintiff for the delay in receiving payment also serves to make her whole, *see Monessen Southwestern R. Co. v. Morgan*, 486 U.S. 330, 335 (1988) (stating the proposition that "[p]rejudgment interest is normally designed to make the plaintiff whole," though finding it unavailable under FELA), Taxpayers argue that it to should be excluded.

While the language of *Reese*, *Wesson* and *Hawkins* read broadly could support excluding any damages that serve to compensate the plaintiff, these cases were simply distinguishing punitive from compensatory damages in order to justify the taxation of punitives. The conclusion that the legislative history demonstrates that damages, to be excludable, must serve a compensatory purpose does not dispose of the issue here, namely whether every type of sum that might serve a compensatory function falls within the scope of § 104(a)(2).

The legislative history is bereft of any direct evidence that Congress ever considered the tax treatment of prejudgment interest.[5] Therefore, we are left to determine

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[5] Taxpayers argue that the 1982 Periodic Payment Settlement Act ("PPSA"), Public L. 97-473, 96 Stat. 2605, § 101, evidences legislative intent that time value of money considerations were not to be treated separately under § 104(a)(2). The PPSA amended § 104(a)(2) and provided that a victim of personal injuries who received damages in periodic payments rather than a lump sum could exclude the entire periodic payment from gross income.

We are not persuaded that the PPSA, which applies solely to periodic payments, sheds light on whether Congress intended to exclude prejudgment interest under § 104(a)(2). There is nothing in the act or in the revenue rulings themselves that indicates a general Congressional or administrative position toward the exclusion of prejudgment interest. Indeed, given the difficult task of differentiating interest and damages in the context of periodic payments, it is quite probable that the driving force behind the act was a concern for administrative convenience. *See* Douglas A. Kahn, *Compensatory and Punitive Damages for a Personal Injury: To Tax or Not to Tax?*, 2 Fla. Tax Rev. 327, 345 (1995).

whether a broad or narrow interpretation of § 104(a)(2) is more consistent with congressional intent.

5. Factors Militating against the Exclusion of Taxpayers' Award of Prejudgment Interest

a. Prejudgment interest is not a traditional remedy for personal injury

Significantly, we note that in construing § 104(a)(2) in other contexts, the Court has emphasized that the traditional tort concepts are relevant to the analysis. *See Burke*, 504 U.S. at 234, 235 (opining that "IRS regulations have linked identification of a personal injury for purposes of § 104(a)(2) to traditional tort principles" and that "one of the hallmarks of traditional tort liability is the availability of a broad range of damages"); *see also Schleier*, 115 S.Ct. 2159, 2163-64 (considering "typical recovery in a personal injury case [to] illustrate[] the usual meaning of 'on account of personal injuries.' "). Although *Burke* was attempting to elucidate the meaning of "personal injury," an issue that is not in dispute in this case, we believe that traditional tort concepts are still relevant, particularly when attempting to discern the meaning of § 104(a)(2) as intended by Congress.

Prejudgment interest was rarely available under the common law, and never for personal injuries.[6] *See Monessen*, 486 U.S. at 337 ("In 1908, when Congress enacted

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[6] Section 104(a)(2) has remained virtually unchanged from its predecessor, § 213(b)(6) of the Revenue Act of 1918, ch. 18, 40 Stat. 1057, 1066 (1919). Section 213 (b)(6) excluded "[a]mounts received . . . as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or

the FELA, the common law did not allow prejudgment interest in suits for personal injury or wrongful death."); 2 Dan B. Dobbs, *Law of Remedies* § 8.4, at 454-55 (Practitioner Treatise Series 1993). The requirement of a liquidated sum, "fixed and known," posed the greatest obstacle towards recovery of such interest. *See* Charles T. McCormick, *Law of Damages* § 54, at 213 (1935).

Thus prejudgment interest, when awarded at all, generally compensated for pecuniary harms, most often easily determinable contractual ones.[7] It is only more recently, pursuant to certain statutes, that prejudgment interest has become recoverable in personal injury suits on nonpecuniary harms. *See*, 1 *Law of Remedies* § 3.6(2), at 346-48 (comparing statutes). While the Colorado statute may contemplate a different understanding of the concept of damages, we believe it is contrary to the concept of damages for personal injuries as understood in the Revenue Act of 1918 and maintained ever since. *See Downey v. C.I.R.*, 33 F.3d 836, 840 (7th Cir. 1994) (characterizing prejudgment interest as a type of contract remedy). Absent an express signal from Congress, *see*

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agreement on account of such injuries or sickness." Given that § 104(a)(2) succeeds § 213(b)(6) in form and substance, damages as understood by Congress in 1919 are relevant to our discussion here.

[7] *See Law of Damages* § 56, at 223-24. In McCormick's opinion, interest should have been allowed in personal injury cases for pecuniary damages such as medical expenditures. *Id.* He noted, however, that "it is generally agreed that juries should not be directed to allow even as a matter of discretion, interest upon damages given for pain, suffering, humiliation, and other like nonpecuniary injuries." *Id.* § 57, at 226.

Monessen, 486 U.S. at 339, we hesitate to interpret "damages on account of personal injury" as broadly as Taxpayers request.

b. Schleier

Moreover, we believe that *Schleier* leads us to the same conclusion. Though not facing this issue, the Court emphasized that there should be a direct link between the injury and the remedial relief. *See* 1215 S.Ct. at 2164 ("Thus, in our automobile hypothetical, the accident causes a personal injury which in turn causes a loss of wages."). In contrast, compensation for the lost time value of money is caused by the delay in attaining judgment. Time becomes the relevant factor, not the injury itself – the longer the procedural delay, the higher the amount. Indeed, often the prejudgment interest award dwarfs the damages award. In short, though it is related to the injury, both in terms of existence and computation, the award of prejudgment interest is not linked to the injury in the same direct way as traditional tort remedies.

c. The default rule

Lastly, though perhaps most importantly, we are guided by the default rule that "exclusions from income must be narrowly construed." *Schleier*, 115 S.Ct. at 2163; *O'Gilvie*, 66 F.3d at 1560. Although we think that the taxation of prejudgment interest is consistent with congressional intent, even if "good reasons tug[ged] each way," we would be required to hold that § 104(a)(2) does not exclude Taxpayers' prejudgment interest award from

income. *O'Gilvie*, 66 F.3d at 1560 (citation and internal quotation marks omitted).

C. Conclusion

We believe that the Taxpayers' construction, although not irrational, contemplates too broad a reading of the exclusion provision, a step we are unwilling to take. The default rule to construe exclusions narrowly, the nature of prejudgment interest, the Court's recent decision in *Schleier*, and the purpose of § 104(a)(2) as we discern it, all lead us to conclude that the prejudgment interest recovered by Taxpayers does not constitute "damages on account of personal injury" under § 104(a)(2).

Reversed.

APPENDIX B

The Memorandum Opinion of the United States District Court for the District of Colorado

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLORADO

Civil Action No. 93-K-2288

MARY BRABSON,

Plaintiff,

v.

UNITED STATES OF AMERICA,

Defendant.

MEMORANDUM OPINION AND ORDER

KANE, J.

Before me on defendant United States' motion to dismiss is the complex question of what constitutes "damages received on account of personal injuries or sickness" under the exclusion from gross income stated in Internal Revenue Code § 104(a)(2). In particular I must determine whether mandatory statutory prejudgment interest, added by operation of law to Colorado personal injury awards under C.R.S. § 13-21-101(1), is an element of "damages" excludable from income within the meaning of § 104(a)(2) or whether it is taxable "interest" within the meaning of § 61(a)(4).

Plaintiffs Mary, Helen, and William Brabson initiated this action against the United States alleging overpayment of their 1988 federal income taxes. The Brabsons claim they were erroneously taxed on the prejudgment interest portion of a personal injury award Mary Brabson obtained against the City of Colorado Springs and others as a result of a gas explosion at the Brabsons' home in 1981. They seek recovery of the $ 371,000 in taxes

assessed and paid on the portion of their damages award attributable to prejudgment interest, plus interest and attorney fees.

The United States moves to dismiss the Brabsons' complaint, asserting prejudgment interest is separate from damages and fully taxable as interest income. I disagree. Based on my review of the Code and caselaw interpreting it, I conclude mandatory statutory prejudgment interest is an element of compensatory "damages" available to plaintiffs pursuing personal injury actions under Colorado law. To the extent this conclusion conflicts with the Tax Court's recent ruling in *Kovacs v. Comm'r*, 100 T.C. 124 (1993), *aff'd in unpublished disposition*, 94 WL 253035 (June 9, 1994), I decline to follow the majority's analysis, and adopt instead the dissent of Judge Beghe.

I. Facts

The following facts are undisputed:

On July 15, 1981, an explosion damaged Mary Brabson's home, injuring Mary and her children, William and Helen. The explosion was linked to a gas leak. Mary Brabson filed suit in El Paso County District Court, naming the City of Colorado Springs, Stratmoor Hills Water District, and Stratmoor Hills Sanitation District as defendants. The case was tried to a jury and a verdict rendered in favor of the Brabsons. On October 29, 1983, the trial court signed a judgment awarding Mary Brabson $ 1,502,150.02 for personal injuries, $ 97,840.98 for property damage, and $ 341,159.10 in prejudgment interest from the date of the explosion to the date of judgment.

The defendants appealed. Before determination of the case by the Colorado Court of Appeals, the Stratmoor Hills defendants settled with Mary Brabson for $ 155,948.87. On November 26, 1986, the Court of Appeals issued an opinion affirming the trial court's judgment.

On February 17, 1987, the City of Colorado Springs filed a petition for writ of certiorari with the Colorado Supreme Court, seeking review of the Court of Appeals' decision. The petition was granted on May 11, 1987. On October 30, 1987, the Brabsons sought leave to execute partially on the judgment. The request was denied by the Colorado Supreme Court on November 10, 1987.

After oral argument on April 25, 1988, the Colorado Supreme Court ordered the petition for writ of certiorari denied as having been improvidently granted. On June 28, 1988, the parties filed a satisfaction of judgment in the El Paso County District Court indicating Mary Brabson received $ 2,888,414.06 in connection with her action against the City of Colorado Springs. Of this, $ 370,723.12 was attributed to mandatory statutory prejudgment interest on the personal injury award.

The Brabsons did not include the prejudgment interest as income on their 1988 federal income tax returns on grounds it constituted damages received on account of personal injuries under 26 U.S.C. § 104(a)(2). The Internal Revenue Service assessed income tax deficiencies against each of the Brabsons for the excluded prejudgment interest, which deficiencies the Brabsons paid. The Brabsons now seek to recover the amounts paid, plus interest and attorney fees.

II. Discussion

As a general rule, "gross income means all income from whatever source derived." 26 U.S.C. § 61(a). All realized accessions to wealth are presumed to be taxable income, unless the taxpayer can demonstrate an acquisition is specifically exempt. *See Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 430 (1955); *Wulf v. City of Wichita*, 883 F.2d 842, 871 (10th Cir. 1989).

Since 1918 Congress has expressly excluded from gross income tort damages received on account of personal injuries. Revenue Act of 1918, § 213(b)(6), 40 Stat. 1066, *discussed in Roemer v. C.I.R.*, 716 F.2d 693, 696 (9th Cir. 1983) (footnote omitted). In its present form at 26 U.S.C. § 104(a)(2), the personal injury damages exclusion provides:

> § 104. Compensation for injuries and sickness.
>
> (a) In general. – Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable, year, *gross income does not include* –
>
> (2) *the amount of any damages received* (whether by suit or agreement and whether as lump sums or as periodic payments) *on account of personal injuries* or sickness. . . .

26 U.S.C. § 104 (emphasis added).[1]

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[1] Section 104, entitled "Compensation for injuries or sickness," also excludes from gross income amounts received for personal injuries or sickness under worker's compensation programs (§ 104(a)(1)), accident or health insurance (§ 104(a)(3)), and certain federal pension programs (§ 104(a)(4)).

Treasury Regulation 1.104-1(c) defines "damages" in this context as "an amount received . . . through prosecution of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution" 26 C.F.R. § 1.104-1(c) (1991). With the exception of punitive damage awards,[2] excludability under § 104(a)(2) and Treasury Regulation 1.104-1(c) turns solely on the nature of the underlying claim, not the nature of the injury. *United States v. Burke*, ___ U.S. ___, 119 L.Ed.2d 34, 44 (1992), *approving analysis in Burke v. United States*, 929 F.2d 1119, 1121 (6th Cir. 1991). If the underlying claim sounds in tort, that is " 'the beginning and the end of the inquiry.' " *Burke*, 929 F.2d at 1121 (quoting *Threlkeld v. Comm'r*, 87 T.C. 1294, 1299 (1986), *aff'd*, 848 F.2d 81 (6th Cir. 1988)); *Horton v. Comm'r*, 100 T.C. 93, 96 (1993) (citing *Burke*). The entire "amount received" through prosecution of that claim is excludable, regardless of whether it includes compensation for non-physical or economic losses, and *regardless of whether it includes elements of damages otherwise taxable.*[3]

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[2] Punitive damage awards are excludable only if the underlying injury is physical. 26 U.S.C. § 104(a)(2) (after 1989 amendment). *See* 1989 Omnibus Budget Reconciliation Act, P.L. 101-239, 12/19/89 (applicable to punitive damage awards received after 7/10/89).

[3] *Horton v. Comm'r*, 100 T.C. 93, 95-6 (1993) (citing *Burke*) (punitive damages excludable); *Downey v. Comm'r*, 97 T. C. 150, 260 (1991) (§ 104(a)(2) excludes from income all damages that substitute for items otherwise taxable or would produce taxable benefit). *See Redfield v. Ins. Co. of North America*, 940 F.2d 542, 545 (9th Cir. 1991) (economic damages received in ADEA case fully excludable, even though based on otherwise taxable lost wages) (adopting view taken by Third and Sixth Circuits in *Pistillo v.*

The exclusion from income under § 104(a)(2) thus is broad, as are the other exclusions in § 104 for "[c]ompensation for injuries or sickness." For example, the exemption for "amounts received" through accident or health insurance for personal injuries or sickness (26 U.S.C. § 104(a)(3)) excludes from income all amounts received under accident or health insurance policies, even if they are in excess of the insured's actual medical expenses (Rev. Rul. 58-602, 1958-2 C.B. 109), and even if they include items otherwise taxable, such as replacement income (Rev. Rul. 58-90, 1958-1 C.B. 88). See 4 U.S. Tax Rep. ¶ 1044.03.[4]

The Tenth Circuit recognizes the breadth of the exclusion in § 104(a)(2). Once it is determined an underlying claim sounds in tort, the Tenth Circuit has ruled the entire amount awarded as damages for personal injuries is excluded under § 104(a)(2). *Wulf v. City of Wichita*, 883 F.2d 842, 873 (10th Cir. 1989). In *Wulf*, the court of appeals reversed the trial court's addition of $ 80,821.97 to a damages award for "taxes due," finding the trial court

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Comm'r, 912 F.2d 145 (6th Cir. 1990) and *Rickel v. Comm'r*, 900 F.2d 655 (3rd Cir. 1990)); *Threlkeld*, 848 F.2d at 84 (all amounts received in compensation of nonphysical personal injury, like amounts received for physical injury, excludable under § 104(a)(2)); *Roemer v. C.I.R.*, 716 F.2d 693, 697 (9th Cir. 1983) (Tax Court erred in requiring amounts received for nonphysical injuries in defamation action allocated into taxable and nontaxable components).

[4] However, the general exclusion in § 104(a)(3) does not apply to amounts received by an employee to the extent the amounts are either attributable to employer contributions not includable in the employee's gross income, or paid by the employer. *See* 4 U.S. Tax Rep. ¶ 1044.03.

had erroneously assumed the damages award, which represented back pay, was taxable. Because the underlying claim – i.e. termination of plaintiff's employment deprived him of his First Amendment rights in contravention of 42 U.S.C. § 1983 – sounded in tort, the Tenth Circuit found the entire damages award excludable from income under § 104(a)(2). *Id.*

> The award of back pay compensated [plaintiff] for the economic injury resulting from the denial of his constitutional rights. It is still an award of damages 'on account of personal injuries,' and is therefore not taxable.

Id. (citing *Bent v. Comm'r*, 835 F.2d 67, 71 (3rd Cir. 1987) (rejecting Commissioner's argument that portion of settlement based on lost wages not excludable from income under § 104(a)(2) because wages otherwise taxable)).

Applying this analysis to the case before me, I first look to the nature of the underlying claim. There is no dispute the Brabsons' suit against the City of Colorado Springs and the Stratmoor Water and Sanitation Districts was a legal action based upon tort. Nor is there a dispute that the prejudgment interest at issue was part of the "amount received" by the Brabsons through prosecution of that action. *See* Treasury Reg. 1.104-1(c).

This alone should be the end of the inquiry. *Kovacs v. Comm'r*, 100 T.C. 124, 145-46 (1993) (Beghe, J. dissenting) (citing *Burke, supra*, 119 L. Ed. 2d 34; *Downey, supra*, 97 T.C. 160-63; *Horton, supra*, 100 T.C. at 96). The United States, however, argues the relevant inquiry is not whether the prejudgment interest was an "amount received" by the Brabsons through prosecution of Mrs.

Brabson's personal injury action, but whether it constitutes "damages" as contemplated in § 104(a)(2). Def.'s Mot. Dismiss at 7. The answer to this question, I find, requires consideration of Colorado personal injury law and a determination of how Colorado views prejudgment interest awarded under C.R.S. § 13-21-101.

A. Colorado law determines what "damages" are available in Colorado personal injury actions.

Because there is no general federal common law of torts (*Erie Railroad Co. v. Tompkins*, 304 U.S. 64, 78 (1938)) nor controlling definitions in the Tax Code, courts interpreting § 104(a)(2) look to state law. *Roemer v. Comm'r*, 716 F.2d at 697, *citing United States v. Mitchell*, 403 U.S. 190, 197 (1971) (quoting *Burnet v. Harmel*, 287 U.S. 103, 110 (1932) (state law creates legal interests, federal law determines when and how to tax)). Consideration of state law is not limited to determining whether a particular action sounds in tort; courts also look to state law to determine the types of "damages" available to the plaintiff in such an action.

Where, under state law, the damages redress the personal injury suffered by the plaintiff, they are excludable under § 104(a)(2). *See Roemer*, 716 F.2d at 700 (all compensatory damages available under California law for defamation excludable from income under § 104(a)(2); *Horton v. Comm'r*, 100 T. C. 93, 100 (1993) (in Kentucky punitive damages serve "both to compensate the injured party and punish the wrongdoer" and are excludable under § 104(a)(2)); *Burford v. United States*, 642 F.Supp. 635, 638, n.5 (N.D.Ala. 1986) (though labeled "punitive,"

Alabama wrongful death awards compensate plaintiff for her loss and thus are excludable from income), *discussed in Miller, supra,* 914 F.2d at 591 (in contrast to *Burford* court's examination of Alabama wrongful death law, examination of Maryland law indicates punitive damages in Maryland defamation action are not awarded compensatory).

Where, under relevant state law, damages are received for some other purpose, they are not excludable under § 104(a)(2). See *Reese v. United States,* 24 F.3d 228, 232 (Federal Circuit concluded punitive damage awards for violation of the District of Columbia Human Rights Act are to deter and punish defendant, not to compensate plaintiff, and punitive damage award not excludable under § 104(a)(2); *C.I.R. v. Miller,* 914 F.2d at 589 (Fourth Circuit looked to Maryland law to conclude punitive damages are "inherently different" from compensatory damages and therefore not excludable under § 104(a)(2)); *Wesson v. United States,* 843 F. Supp. 1119, 1122 (S.D.Miss. 1994) (same, applying Mississippi law); *O'Gilvie v. United States,* 1992 WL 12306 at *1 (D.Kan. May 26, 1992) (same, looking to Kansas law).

The question to be decided, then, is whether prejudgment interest is an element of available compensatory damages in Colorado personal injury actions.

B. Under Colorado law, prejudgment interest on personal injury awards is an element of compensatory damages, not interest.

In determining what constitutes "damages" under state law for the purposes of § 104(a)(2), courts are not

bound by labels. *See, e.g., Burford v. United States,* 642 F.Supp. at 638 (N.D.Ala. 1986) (relying on Alabama caselaw to deconstruct "punitive damages" label attached to wrongful death awards under Alabama statute), *analysis approved, C.I.R. v. Miller,* 914 F.2d at 591 (4th Cir. 1989). Thus, I look to Colorado caselaw interpreting C.R.S. § 13-21-101 to determine whether prejudgment interest is an element of damages for personal injury, rather than rely on the fact it is called "interest."

Under Colorado law, "prejudgment interest is an element of compensatory damages in actions for personal injuries, awarded to compensate the plaintiff for the time value of the award eventually obtained against the tortfeasor." *Allstate Ins. Co. v. Starke,* 797 P.2d 14, 19 (Colo. 1990) (citing, *inter alia, Houser v. Eckhardt,* 532 P. 2d 54, 57 (Colo.App. 1975) , *aff'd on other grounds sub nom., Security Ins. Co. v. Houser,* 191 Colo. 189, 552 P.2d 308 (1976)). It is "in the nature of another item of damages" wholly distinct from postjudgment interest. *Houser,* 532 P.2d at 57 (citing *Lineman v. Schmid,* 195 P.2d 408 (Cal. 1948) and *Turcotte v. Dewitt,* 131 N.E.2d 195 (Mass. 1956)).

The difference between prejudgment, or moratory,[5] interest and conventional interest is fundamental. The

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[5] In *Starke,* the Colorado Supreme Court found C.R.S. § 13-21-101 "codifies the moratory interest principle in those tort actions for personal injuries to which (the statute) applies." 797 P.2d at 19. Moratory interest, or interest as damages, has been allowed in Colorado for over one hundred years. *Id.* at 18 (citations omitted). As viewed by the Colorado Supreme Court

obligation to pay prejudgment interest is tied inextricably to the concept of fault. Before liability is fixed, prejudgment interest is part of plaintiff's damage demand on a contingent and unliquidated claim and accrues until judgment enters against the defendant. *Starke*, 797 P.2d at 19; *Houser*, 532 P.2d at 57. Once defendant's liability in tort is fixed, his liability for the lost time-value of plaintiff's award also becomes fixed. Prejudgment interest is awarded to compensate for this loss and becomes a "part" of plaintiff's lump-sum damages. C.R.S. § 13-21-101; *see Turcotte*, 131 N.E.2d at 197 (damages is the word expressing in dollars and cents the injury sustained by a personal injury plaintiff; it includes both the original damage and whatever interest is added to make the plaintiff whole).

The obligation to pay postjudgment interest, by contrast, is not directly tied to the concept of fault. Like conventional interest, postjudgment interest accrues on a fixed indebtedness. *See Old Colony Railroad Co. v. Comm'r*, 284 U.S. 552, 560 (1932). It compensates a judgment creditor for the debtor's use, or the creditor's forbearance in demanding, payment of an amount fixed and owed by the debtor. *See Deputy v. du Pont*, 308 U.S. 488, 498 (1940). It is the equivalent of "rent" for the use of funds due and owing to the plaintiff. *See Dickman v. Comm'r*, 465 U.S. 330, 339 (1984). Prejudgment interest does not fit into

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> [t]he term 'moratory *interest*' is misleading, for where allowed it is awarded not as interest as such but as damages.

797 P.2d at 18 (citing *Bankers Trust Co. v. Int'l Trust Co.*, 113 P.2d 656, 665 (Colo. 1941)) (emphasis original).

these definitions of interest because at the time it accrues, plaintiff is not a creditor and there is no debt fixed or owed by the defendant to him. Plaintiff can neither demand, nor forbear from demanding, payment.

I conclude as a matter of Colorado law, prejudgment interest is an element of damages compensating the personal injury plaintiff for all injuries caused by defendant's tortious conduct, including the lost time value of his damages award. It is not "interest" as that term is defined and generally understood.

The United States argues a determination that prejudgment interest is "damages" under Colorado law does not support a conclusion that prejudgment interest is "damages" for the purpose of § 104(a)(2). Mot. Dismiss Amended Complaint at 11, *citing Aames v. Comm'r*, 94 T.C. 189, 192-93 (1990). Based on my analysis in Section II(A), *supra*, I find this argument unpersuasive. The Internal Revenue Code and its regulations are vague at best as to what constitutes an "amount received (other than workmen's compensation) through prosecution of a legal suit or action based upon tort or tort type rights" (Treas. Reg. § 1.104-1(c)). Under the principle set forth in *Erie*, I must look to Colorado law to determine the type and nature of "damages" available in Colorado personal injury actions.

Though not entirely clear, the *Aames* opinion upon which the United States relies appears to concern the excludability under § 104(a)(2) of postjudgment, rather than prejudgment, interest. *See* 94 T.C. at 190 (interest awarded from date jury verdict against attorney reduced by trial judge to the date reduced verdict affirmed by court of appeals). Moreover, none of the cases cited in

Aames involved the taxation of personal injury damage awards or § 104(a)(2). *E.g., Wheeler v. Comm'r*, 58 T.C. 459 (1972) (excludability of damages awarded in breach of contract action); *Kieselbach v. Comm'r*, 317 U.S. 399 (1943) (excludability of interest on condemnation award under return of capital theory).[6] Because neither breach of contract damages nor condemnation awards fall within the exclusion for personal injury damages in § 104(a)(2), I find the *Aames*'s analysis unenlightening and undeterminative of the question before me.

The United States also demurs to the *Houser-Starke* line of Colorado cases as irrelevant because they involve the interpretation of coverage issues under liability

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[6] Cases in which interest on condemnation awards is deemed includable in income are inapposite. The interest portion of a condemnation award is expressly defined as "interest" in Treasury Regulation § 1.61-7(a):

> Interest income includes interest on savings or other bank deposits; interest on coupon bonds; interest on an open account, a promissory note, a mortgage, or a corporate bond or debenture; the interest portion of a condemnation award; usurious interest (unless by State law it is automatically converted to a payment on the principal); interest on legacies; interest on life insurance proceeds; interest on life insurance proceeds held under an agreement to pay interest thereon; and interest on refunds of [f]ederal taxes.

26 C.F.R. § 1.61-6 (1991). If probative of anything, the inclusion on this list of interest and condemnation awards and the omission of prejudgment interest on personal injury awards suggests the latter is *not* "interest" within the meaning of § 61 of the Tax Code.

insurance policies.[7] Mot. Dismiss Amended Complaint at 11-12. I disagree. The caselaw forming the basis for the Colorado Court of Appeals' analysis in *Houser*, adopted by the Colorado Supreme Court in *Starke*, did not involve insurance policies or coverage issues. *See Turcotte v. DeWitt*, 131 N.E.2d 195 (Mass. 1955) (wrongful death action); *Lineman v. Schmid*, 195 P.2d 408 (Cal. 1948) (breach of contract action). Further, Colorado's recognition of moratory interest principles, codified in personal injury actions by C.R.S. § 13-21-101, is not limited to insurance policy coverage issues. *See generally* Tredennick & Cairns, *Collecting Pre- and Post-Judgment Interest in Colorado: A Primer*, 15 Colo. Law. 753 (1986).

Looking, as I must, to state law to determine the nature of prejudgment interest, I conclude it is an element of "damages" available to plaintiffs "on account of personal injury or sickness" and thus excludable from income under § 104(a)(2).[8]

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[7] In both *Houser* and *Starke*, statutory prejudgment interest was deemed to be an element of damages as opposed to interest and therefore subject to insurance policy limits for bodily injuries. It is interesting to note the words "demur" and "moratory" both derive from the latin *morari*, "to delay." Webster's Third New Int'l Dictionary (1976 ed.)

[8] Under my analysis, tax treatment of personal injury prejudgment interest under § 104(a)(2) may vary from state to state. This fact alone, however, is immaterial. As has long been a fundamental principle in tax law, the constitutional requirement of uniformity is not intrinsic, but geographic. *Poe v. Sanborn*, 282 U.S. 101, 117 (1930) (citations omitted).

C. Kovacs and its progeny.

I am aware my conclusion in this case is different from that reached by the United States Tax Court in *Kovacs v. Comm'r*, 100 T.C. 24 (1993), *aff'd in unpublished disposition*, 1994 WL 253035 (6th Cir. June 9, 1994) and its progeny. *E.g.*, *Rice v. United States*, 834 F.Supp. 1241, 1245 (E.D.Cal. 1993) (relying on *Kovacs*); *Burns v. C.I.R.*, T.C. Memo. 1994-284 (June 21, 1994) (same). In *Kovacs*, the Tax Court cited a disinclination to interpret the term damages in § 104(a)(2) "broadly" or "overrule" previous opinions and concluded mandatory statutory prejudgment interest awarded under a Michigan statute fell outside the scope of § 104(a)(2) and was taxable "interest" income within the meaning of § 61(a)(4). 100 T.C. at 127-28 (construing M.C.L. § 600.6013 (1987)). Because my contrary conclusion requires neither a broadening of the term "damages" nor the overruling of pre-*Kovacs* opinions, I decline to follow the *Kovacs* majority and adopt instead the analysis of Judge Beghe in dissent.

1. Pre-*Kovacs* Tax Court and IRS interpretations of § 104(a)(2) and its predecessors.

The conclusion I reach in the instant case conforms, rather than conflicts, with federal tax law in general and the Tax Court's view of § 104(a)(2) in particular. In an

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> Differences in state law, which may bring a person within or without the category designated by Congress as taxable, may not be read into the Revenue Act to spell out a lack of uniformity.

Id. at 118 (citation omitted).

opinion issued 15 days before *Kovacs*, the Tax Court reaffirmed the analysis to be applied in questions of excludability under § 104(a)(2). *See Horton v. C.I.R.*, 100 T.C. 93, 95-7 (February 9, 1993) (rejecting Fourth Circuit's limited view of excludability under § 104(a)(2) with respect to punitive damages. *Miller v. Comm'r*, 914 F.2d 596 (1990)). Relying on its opinions in *Downey* and *Miller*, and the United States Supreme Court's opinion in *Burke*, the Tax Court stated:

> The beginning and end of the inquiry should be whether the damages were paid on account of 'personal injuries.' This inquiry is answered by determining the nature of the underlying claim. Once the nature of the underlying claim is established as one for personal injury, any *damages* received on account of that claim . . . are excludable.

Horton, 100 T.C. at 95-96 (emphasis added).

The Tax Court's analysis of what is meant by the word "damages" in this context is illuminating:

> Whether the damages paid to the tort victim reflect a substitute for amounts or items otherwise taxable or a substitute for amounts or items to be enjoyed without a tax consequence is irrelevant. Thus, section 104(a)(2) permits the exclusion of damages that are a substitute for the enjoyment of a whole body or of freedom from distress. Likewise, the section allows exclusion of damages that are a substitute for *amounts* or *items* that *otherwise would be taxable* or would potentially produce taxable benefit, such as income lost as a result of a personal injury or amounts reflecting injury to a person's business or professional reputation.

Horton, 100 T.C. at 96 n.4, *quoting Downey v. Comm'r*, 97 T.C. at 163-64 (emphasis added). The analysis is clear: when items otherwise taxable are awarded as damages for personal injuries, their character as "otherwise taxable" becomes irrelevant and they are excluded from income. Thus, even if prejudgment interest were "otherwise taxable," once it is awarded as damages for personal injuries, that fact becomes irrelevant and it is excludable from income.

In reaching its conclusion in *Kovacs*, the majority relies heavily on the 1933 Board of Tax Appeals decision in *Riddle v. Comm'r*, 27 B.T.A. 1339. The Tax Court credits *Riddle* with having articulated the "longstanding" judicial view that prejudgment interest is includable in gross income. *See* 100 T.C. at 129-30. As Judge Beghe points out in his dissent in *Kovacs*, the "longstanding" judicial view of prejudgment interest is, if anything, contrary to the majority's interpretation of *Riddle*. *Id.* at 155-56 (Beghe, J. dissenting).

Riddle, like *Aames*, concerned the taxability of postjudgment, not prejudgment, interest.[9] The Board of Tax

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[9] As Judge Beghe notes, *Riddle* concerned the taxability of postjudgment interest on a $ 15,000 award by the Mixed Claims Commission for personal injuries suffered in the sinking of the steamship Lusitania in 1915. *See Kovacs*, 100 T.C. at 154 (Beghe, J. dissenting), *discussing Riddle*, 27 B.T.A. at 1340. The interest had accrued from November 1, 1923, the date of the award, to 1928, when it was paid. *Riddle*, 27 B.T.A. at 1339. Under the law applicable to the Mixed Claims Commission at that time, interest was not allowable as damages from the time of loss, but only from the time the loss was fixed and liquidated by the Commission. *Id.* at 1340. The Board of Tax Appeals concluded

Appeals' conclusion that *post*judgment interest is "separately computed and specifically designated interest" and therefore includable in income, 27 B.T.A. at 1341, simply does not support the *Kovacs* majority's conclusion that prejudgment interest is includable in income. The more relevant case for determining the "longstanding" view of prejudgment interest is one decided three years after *Riddle, NV Koninlijke Hollandische Lloyd (Royal Holland Lloyd) v. Comm'r*, 34 B.T.A. 830, 835 (1936), in which the Board of Tax Appeals explicitly distinguished "separable" items of interest includable in income from prejudgment interest awarded as damages.

Royal Holland involved the unlawful detention by the United States of the Royal Holland Lloyd vessel Zeelandia from October 22, 1917, to March 21, 1918. The Lloyd asserted a claim against the United States for damages arising out of the United States' refusal to let the Zeelandia leave, and tried for several years to resolve the matter through diplomatic channels. 34 B.T.A. at 831. On March 3, 1927, Congress enacted the Act for the Relief of the Royal Holland Lloyd, sustaining the Lloyd's claim and permitting it to sue the United States for damages in the Court of Claims. *Id.* at 831-32.

On December 7, 1931, the Court of Claims found for the Lloyd, finding it was entitled to recover $ 446,826.22, together with interest. On July 18, 1932, the United States issued a warrant in favor of the Lloyd in the amount of $ 532,356.95 in partial payment of the judgment of the

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the $ 3,422.61 in postjudgment interest was paid to and received by the taxpayer as interest eo nomine and was thus includable in gross income. *Id.* at 1341.

Court of Claims. 34 B.T.A. at 832. This payment included $ 84,531.73 in interest. *Id.*

On May 24, 1933, the Collector of Internal Revenue sent a letter to the Lloyd in Amsterdam stating the Lloyd had realized taxable income for the year 1932 as a result of the Court of Claims' judgment. *Royal Holland*, 34 B.T.A. at 833. The Lloyd filed the requested return, but asserted no part of the court's judgment constituted taxable income. *Id.* The Commissioner assessed a deficiency, finding the Court of Claims' award, which included interest for the period of the detention through the date of judgment, was taxable income from sources within the United States pursuant to § 119(a)(4) of the Revenue Act of 1932 (now codified at 26 U.S.C. § 861). *Id.*

The Board of Tax Appeals disagreed. It determined the judgment was obtained "as just compensation for damages for the unlawful detention of the petitioner's property." 34 B.T.A. at 834. Specifically, the Board concluded none of the payment constituted taxable "interest" within the meaning of § 119 because, "under well established rule, the 'interest' was included in the judgment as part of just compensation for damages sustained." *Id., citing Seaboard Air Line Railway v. United States*, 261 U.S. 299 (1923); *Brooks-Scanlon Corp. v. United States*, 265 U.S. 106 (1923); *Phelps v. United States*, 274 U.S. 341 (1927).

> Just compensation for the damage so suffered requires that the party damaged be made whole. An integral part of a payment for such purpose is interest covering the period of detention. In such a case [interest] is merely a convenient method of measuring the amount of one of the

> factors of damage. *It is not a separable item of interest on an obligation.*

Royal Holland, 34 B.T.A. at 835 (emphasis added).

I find the Board's analysis in Royal Holland instructive on the question of whether prejudgment interest (or interest awarded as damages) is a "separable" item of interest for tax purposes. The Board concluded it was not, and I decline to read the earlier *Riddle* decision as the *Kovacs* majority does.

2. "Interest is Interest"

The *Kovacs* majority invokes the following syllogism to conclude prejudgment interest awarded as damages in personal injury actions is not "damages" excludable from income under § 104(a)(2): prejudgment interest is "interest"; "interest" is not "damages"; therefore prejudgment interest is not "damages" excludable from income under § 104(a)(2). *See* 100 T. C. at 128-29. The cornerstone of the majority's analysis, and the one without which it fails, is the conclusory maxim "interest is interest." This tautology withers under scrutiny, and I decline to follow it.

a. The distinction between prejudgment and postjudgment interest.

Although a time value of money element inheres in both prejudgment and postjudgment interest, there is a long history of legal precedent treating them differently. Prejudgment interest is viewed as a part of the damages received "on account" of the injury giving rise to a claim because it accrues while that claim is contingent, whereas

postjudgment interest is considered interest *eo nomine* because it accrues on an indebtedness fixed by final court order. *Kovacs*, 100 T.C. at 142, (Beghe, J. dissenting), *citing* McCormick, *Handbook on the Law of Damages*, § 50, at p. 205 (1935); Dobbs, *Law of Remedies*, § 3.5, at p. 164 (1973). There is a sharp distinction between the two: interest *eo nomine*, "conventional" or promised interest, is paid as a term of contract; prejudgment interest, or interest as damages, is not based on promise, but awarded as a matter of law as compensation for the withholding of money or compensation due. McCormick, *supra*, at 205.

Though ignored by the *Kovacs* majority, federal tax law recognizes this distinction. As an example, Judge Beghe points to tax cases dealing with prejudgment interest and the deduction under 26 U.S.C. § 163(a) for "interest paid or accrued . . . on indebtedness." *Kovacs*, 100 T.C. at 143-44 (dissenting opinion). Under the analysis in these cases, prejudgment interest included in an award on a noncontractual claim is damages, and is not deductible by the payor as "interest" on indebtedness because there is no debtor-creditor relationship between the parties until judgment is entered. *Id.*, *citing Midkiff v. Comm'r*, 96 T.C. 724, 734-35 (1991); *Bettendorf v. Comm'r*, 3 B.T.A. 378, 383-84 (1926); *Jordan v. Comm'r*, 60 T.C. 872, 881, *aff'd per curiam*, 514 F.2d 1209 (8th Cir. 1975). Only after judgment enters does a debt arise and "interest" accrue for the purposes of § 163(a). *Id.*, *citing Bettendorf*, 3 B.T.A. at 382 (in fraud action, interest included in judgment as damages for the wrongful detention of money was damages, not "interest").

After *Kovacs*, then, prejudgment interest is "damages," not interest, for purposes of the deduction for

interest under § 163(a); but it is "interest," not damages, for purposes of the exclusion from income under § 104(a)(2). The *Kovacs* majority provides no reasoned basis for this result and I find it anomalous. Federal income tax law long has recognized the distinction between pre- and postjudgment interest, treating only the latter as "interest" for tax purposes.

b. "Interest" is not always "interest."

The cornerstone of the *Kovacs* majority's analysis, i.e., "interest is interest," also ignores the Tax Court's own directive to "look beyond nomenclature" in determining whether an amount labelled "interest" is indeed "interest." *Albertson's, Inc. v. Comm'r*, 95 T.C. 415 (1990); *see Midkiff, supra*, 96 T.C. at 734 ("interest" label attached to 5% blight of summons damages is not determinative of federal tax consequences).

In *Albertson's*, the Tax Court undertook to determine whether amounts designated as "interest" in deferred compensation arrangements ("DCA's") between a corporate taxpayer and certain of its executive employees and board of director members were in fact "interest" deductible in the year accrued or "compensation" not deductible until paid. 95 T.C. at 420-21. Acknowledging a time-value of money element inhered in the amounts labelled "interest," the Tax Court nevertheless concluded these amounts were not "interest," but "compensation." *Id.* at 421-23. The following language from *Albertson's* reveals the gossamer of the *Kovacs* majority's analysis:

> In determining the effect of a transaction for income tax purposes, formalities such as nomenclature . . . [are] not controlling. [Citations omitted.] The important consideration is substance, not form. [Citations omitted.] The fact that certain amounts are *described* as interest by the parties and are *calculated* by applying a percentage rate per annum, to some principal amount *does not mean that the amounts will be treated as interest for income tax purposes.* [Citation omitted.]

Id. at 422-23 (emphasis added).

The Tax Court then determined the amounts described as "interest" in the DCA's represented neither payments made by the taxpayer for the use of money "borrowed"; liabilities owed to the DCA participants for the "forbearance" of money whose payment had become due; nor "rent" for the use of funds because the DCA participants had no legal right to demand their payment as they accrued, and the taxpayer had no obligation to pay them. *Id.* at 421, 423 (citing *Old Colony, supra,* 324 U.S. at 560; *Deputy v. du Pont, supra,* 308 U.S. at 498; and *Dickman, supra,* 465 U.S. at 339). Thus, it concluded, the amounts described as "interest" were not truly "interest," and could not be deducted from income under § 163. *Id.* at 423.

The *Kovacs* majority, however, engaged in no such analysis. Had it done so, it would have concluded mandatory statutory prejudgment interest, like the "interest" in *Albertson's,* is *not* "interest" for income tax purposes. Prejudgment interest is not a payment made by a personal injury defendant for use of money "borrowed"; a liability owed plaintiff for the "forbearance" of money

whose payment had become due; or "rent" for the use of funds owned by the plaintiff because at the time it accrues, the personal injury plaintiff has no legal right to demand payment and defendant has no legal obligation to pay. *See Albertson's*, 95 T.C. at 423.

Instead, the Tax Court in *Kovacs* did precisely what it directed courts not to do in *Albertson's*: It looked to the Michigan prejudgment interest statute and concluded prejudgment interest is "interest" because it is called "interest" and is calculated separately by applying a percentage rate per annum to the principal amount of the plaintiff's damages award. *Kovacs*, 100 T.C. at 128-29. By elevating form over substance, the *Kovacs* majority arrived at a conclusion unsupported as a matter of law and logic.

3. The exclusion of statutory prejudgment interest from income comports with congressional intent.

Finally, I agree with the dissents of both Judge Beghe and Judge Halpern in *Kovacs* on the issue of congressional intent. In 1982, Congress amended § 104(a)(2) to clarify the exclusion for personal injury awards applies to amounts received as periodic payments, as well as those received in a lump sum. 1982 Periodic Payment Settlement Act, P.L. 97-473, 1/14/83 (adding the language "whether by suit or agreement and whether as lump sums or as periodic payments"), *discussed in* 4 U.S. Tax Rep. ¶ 1044.02 (1994); *see Kovacs*, 100 T.C. at 134-37 (Halpern, J. dissenting), 100 T.C. at 151-53 (Beghe, J. dissenting).

The PPSA specifically was intended to codify the law as it existed in 1982. *Kovacs*, 100 T.C. at 135 (Halpern, J. dissenting) (citing S.Rept. 97-646 (1982), 1983-1 C.B. 514, 515 and E.Rept. 97-832 (1982)). In place at that time was a Revenue Ruling, in which the IRS stated a victim of personal injuries who received damages in periodic payments could exclude from income the entire amount of each payment under § 104(a)(2), not just its present value. Rev. Rul. 79-220, 1979-2 C.B. 74. This fact, coupled with Congress's expressed intent in the PPSA to treat personal injury damages the same under § 104(a)(2) regardless of whether received in periodic payments or a lump sum, supports the conclusion that § 104(a)(2) is intended to exclude from income the entire personal injury damages award, including prejudgment interest. *Kovacs*, 100 T.C. 136-37 (Halpern, J. dissenting), 152-53 (Beghe, J. dissenting).

III. Conclusion

Under Colorado law, mandatory statutory prejudgment interest awarded in personal injury actions is an element of compensatory damages, not interest. It is therefore excludable from income as "damages" received on account of personal injuries or sickness under § 104(a)(2) of the Tax Code. This conclusion comports with federal tax law as it existed before *Kovacs*. I find the Tax Court majority's analysis in *Kovacs* unpersuasive, and decline to follow it.

Dated this 24 day of October, 1994, at Denver, Colorado.

/s/ John L. Kane, Jr.
JOHN L. KANE, JR.
U.S. SENIOR DISTRICT
COURT JUDGE

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLORADO

CIVIL ACTION NO. 93-K-2288

MARY BRABSON, *et al.*,

Plaintiffs,

v.

UNITED STATES OF AMERICA,

Defendant.

ORDER

THIS MATTER HAVING COME BEFORE THE COURT upon the parties' Stipulation, and the Court having reviewed the Stipulation, HEREBY ORDERS:

1. Judgment shall be entered on the basis of the Court's Memorandum and order dated August 15, 1994. The entry of this judgment is without prejudice to the right of the defendant to appeal from such judgment, and the parties do not waive any argument or theory which might have been raised in this action.

2. The Clerk shall enter judgment in favor of the plaintiffs as follows:

a. Judgment shall be entered in favor of plaintiff Mary Brabson for overpaid 1988 individual income taxes in the amount of $225,276.00, plus $74,097.88 for interest paid thereon, plus $2,252.76 for penalties paid thereon, together with interest thereon according to law;

b. Judgment shall be entered in favor of plaintiff William Brabson for overpaid 1988 individual income taxes in the amount of $43,737.00,

plus $14,012.26 for interest paid thereon, plus $218.68 for penalties paid thereon, together with interest thereon according to law; and

c. Judgment shall be entered in favor of plaintiff Helen Brabson for overpaid 1988 individual income taxes in the amount of $25,697.00, plus $8,540.07 for interest paid thereon, plus $256.97 for penalties paid thereon, together with interest thereon according to law.

Dated this 24 day of October, 1996, at Denver, Colorado.

/s/ John L. Kane, Jr.
JOHN L. KANE, JR.
U.S. SENIOR DISTRICT
COURT JUDGE

APPENDIX C

Summary of State Law on Prejudgment Interest

STATES ALLOWING PREJUDGMENT INTEREST IN PERSONAL INJURY/WRONGFUL DEATH CASES

STATE	DISCUSSION
Alaska § 09-30-070	From date of original offer to settlement.
California Cal.Civil Code: § 3287	Date of Plaintiff's original offer to settle. If Plaintiff makes offer and defendant refuses, Plaintiff is entitled to prejudgment interest if subsequent award exceeds original offer.
Colorado § 13-21-101	Date the action accrued Punitive damages excluded from prejudgment interest calculation.
Connecticut § 52-192a	Date of filing complaint if Plaintiff offers to settle, defendant refuses, and Plaintiff obtains a judgment equal to or greater than the original offer, if the offer was filed within 18 months, from filing the complaint. If offer filed after 18 months compute interest from date offer of judgment filed.
Georgia § 51-12-14	If defendant does not pay Plaintiff's demand for settlement within 30 days, Plaintiff is entitled to interest from date 30 days after initial demand if judgment is for amount not less than amount demanded. If plaintiff refuses defense offer to pay demand for settlement within 30 days, plaintiff is not entitled to interest at judgment.

Hawaii §§ 478.1 and 478.3	Discretion of court provided earliest date is the date when injury occurred. *Towey v. Catling,* 743 F.Supp. 738 (D. Haw. 1990).
Indiana § 34-4-37-10 § 34-4-37-8 § 34-7-37-4 § 34-4-37.5	Discretionary by Court. Period must not be more than 8 months and must be *latest* of one of the following (1) 15 months after cause of action accrued, (2) 6 months after the claim is filed in court of (3) 180 days after a medical review panel is formed to review the claim. Applies to any civil action arising out of tortious conduct. Does not apply to claims against compensation fund. Does not apply to part of an award representing punitive damages.
Iowa § 668.13	Date of commencement of action. Personal injury and wrongful death actions. Does not apply to future damages.
Louisiana § 13:§ 51120 La. Revised Stats	Date of judicial demand. Personal injury and wrongful death.
Maine § 1602	Date sworn notice of claim served upon the defendant. Accrual is suspended during any continuances granted for periods exceeding 30 days. Civil actions except those involving a contract.
Maryland C.J. § 11-301	From date action is filed. Only in cases where defendant or defendant's insurer causes unnecessary delay in having action ready or set for trial in automobile liability claims.

Massachusetts Ch. 231 § 6B	Date of commencement of the action. Personal injury.
Michigan Mich. Compiled Laws Ann. § 600.6013(6)	Date of filing action. Any civil action filed after 1/1/87.
§ 600.6013(7)	If Plaintiff rejects a reasonable offer of settlement, filed with the court, the court shall disallow interest beyond the date of rejection of the written offer of settlement.
§ 600.6013(8)	If a settlement offer is not tendered by the party against whom judgment is subsequently rendered, or is not filed, interest shall accrue from the filing of the complaint.
Minnesota § 549.09	Commencement of action; demand for arbitration; or written notice of claim. Action must be commenced within 2 years of notice. If an offer to settle is entered, interest accrues from time of commencement of the action until the time of the verdict, only if the amount of their offer is closer to the judgment than the opposing party's offer. If the amount of the losing party's offer was closer to the judgment than the prevailing party's offer, the prevailing party shall receive interest only on the amount of the settlement offer or the judgment, whichever is less, from the date of commencement to the date the settlement offer was made.

	Applies in civil actions and arbitrations. Does not apply to workers' compensation cases, dissolutions, future damages, or punitive damages, attorney's fees.
Missouri § 408.040	If a claimant has made a demand for payment of a claim or an offer of settlement and the amount of judgment exceeds the demand for payment or offer, interest shall be calculated from a date 60 days after the demand or offer was made or date the offer was rejected, whichever is earlier. Tort cases.
Montana § 27-1-210	30 days after claimant presents a written statement to the opposing party or his agent stating the claim and how the specific sum was calculated. Personal injury cases, but does not apply to pain and suffering, mental anguish or suffering; injury to credit, reputation or financial standing, exemplary or punitive damages, or attorney fees.
Nebraska § 45-103.01	From date of Plaintiff's first offer of settlement which is exceeded by the judgment under the following conditions (1) the offer is in writing (2) the offer is not made within 10 days before trial, (3) a copy and proof of delivery is filed with the court; and (4) the offer is not accepted prior to that or within 30 days of the date of the offer, whichever occurs first.

Nevada § 17.115 § 17.130	From time of service of summons and complaint, except for future damages, which draw interest from the date of the entry of the judgment. If an offer to settle is made and not accepted, and if the party to whom the offer of judgment is made fails to obtain a more favorable judgment, no prejudgment interest can be recovered from the period between service and entry of judgment.
New Hampshire § 524.1-b	From date action is commenced.
New Jersey NJR of Civ. Pract. 4:42-11	From the date of the institution of the action or from a date 6 months after the date the cause of action arises, whichever is later, provided that in exceptional cases the court may suspend the running of such prejudgment interest.
New Mexico § 56-8-4	From entry of judgment and decree. From date complaint is served ONLY (1) if Plaintiff was not the cause of unreasonable delay in the adjudication of the Plaintiff's claims and (2) if the defendant had previously made a reasonable and timely offer of settlement to the Plaintiff. Prejudgment interest now available in any other situation. If judgment is based on tortious conduct, bad faith, intent or wilful acts, interest 15%.
New York § 5-4.1 Civil Practice Law & Rules	Date of decedent's death. Wrongful Death. EPTL

North Carolina § 24-1	Commencement of action. Actions other than contract.
Ohio § 1343.03	From date cause of action accrued if the court determines personal injury at a subsequent hearing that the party required to pay the money failed to make a good faith effort to settle the case and the party to whom the money is to be paid made a good faith effort to settle the case.
Oklahoma § 12, O.S. § 727	From date the action is commenced.
Pennsylvania Rule 238. Pa.R.Civ.Pro.	After 8/1/89: From a date one year after the date original process was first served in the action up to the date of the award, verdict or decision. Only awarded if it is found that defendant(s) delayed the action. Applies to all civil actions, except eminent domain proceedings.
Rhode Island § 9-21-10	From the date the cause of action accrued. From date of written notice of the claim to the insurer or health care provider, or the filing of the claim whichever occurs first. Civil Actions.
South Dakota § 21-1-13.1	From date of loss. Not recoverable on future damages, punitive damages, loss of consortium, injury to credit, reputation or financial standing, loss of enjoyment of life or loss of society and companionship, pain & suffering, emotional distress.

Texas § 5069.1.05	Beginning the 180th day after the date the defendant receives written notice of a claim or on the day the suit is filed, whichever occurs first. If judgment for claimant is less than the amount of the settlement offer by the defendant, prejudgment interest does not include prejudgment interest settlement offer for the period during which the offer may be accepted. If judgment for claimant is more than the offer made by defendant, prejudgment interest does not include prejudgment interest on the amount of the settlement offer for the period during which the offer may be accepted. Additionally, the judge has discretion to allow/disallow prejudgment interest during periods of delay considering (1) delays caused by defendant and (2) delay caused by a claimant.
Utah § 78-27-44	Only on special damages from the date of the occurrence of the act giving rise to the cause of action to the date judgment is entered.
Vermont	Where a liquidated or readily ascertainable sum of money is involved, the party is entitled to interest from the date of commencing the action. Where a jury is not able to ascertain a specific sum (pain and suffering) a sum may be awarded by the jury in lieu of prejudgment interest. Available in Torts and Wrongful Death.

Virginia 8.01-382	The jury may provide for interest on any award, fixing the period at which the interest shall commence.
West Virginia § 56-6.31 382 S.E.2d 536 (W.Va. 1989)	Only applies to special damages or liquidated damages from the date the cause of action accrued.
Wisconsin § 807.01(4)	If there is an offer to settle which is not accepted and the party recovers a judgment greater than or equal to the offer, the party is entitled to prejudgment interest from the date of the offer of settlement.